The Business Situation

The pace of economic activity slackened noticeably in October and November. Industrial production, payroll employment, and personal income all posted substantial declines, and the unemployment rate edged upward to 5.8 percent. While the strike at the General Motors Corporation was the principal factor behind these developments, the available evidence suggests that the declines in output and employment were also widespread among industries other than those obviously affected by the strike. The latest surveys of plant and equipment spending plans for 1971 confirm the weak outlook that has been portrayed in other recent surveys of business capital spending—especially after allowing for the expected increases in capital goods prices. On a more optimistic note, corporate profits increased somewhat in the third quarter and activity in the residential construction sector has continued to show a strong upward thrust. Also, the settlement of the lengthy General Motors strike in late November should result in a substantial near-term stimulus for the economy, as that corporation strives to make up two months of lost production.

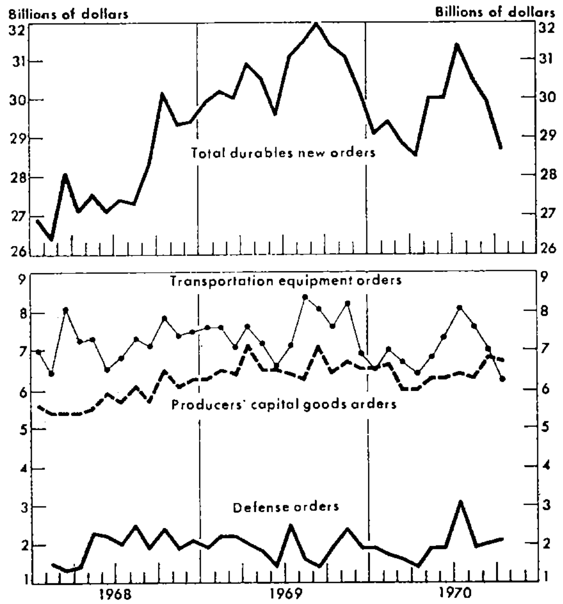
On the price-wage front, the performance of most key indicators remains very disappointing. In October, consumer prices rose at a substantial rate which matched the large September increase. Moreover, while wholesale prices of industrial commodities on a seasonally adjusted basis were unchanged in November, that development came on the heels of an extremely large October advance. Wages continue to rise at extraordinarily rapid rates, and newly negotiated contracts, including the agreement between General Motors and the United Automobile Workers, give little reason for optimism that a significant slowing of wage increases is imminent. Clearly, the realization of a reasonable degree of price stability will prove difficult against a background of wage hikes of the magnitude currently prevailing.

INDUSTRIAL PRODUCTION, ORDERS, SHIPMENTS, AND INVENTORIES

Partly as a result of the automotive strike, industrial production nose-dived during October, dropping 2.3 percent to 162.3 percent of its 1957-59 average. The Federal Reserve Board's index of industrial output is now 7 percent below the peak attained in July 1969. The October decline in production was centered in motor vehicles and parts, iron and steel, and business equipment. Only about one half of the month's decline in output can be attributed to the direct effects of the strike on automobile output and on the output of firms supplying the automobile industry. Defense-related production continued along its downward trend. Moreover, the index for business equipment dropped a substantial 1.7 percent to 178.0 percent of the 1957-59 average and is now 11.4 percent below the October 1969 level. The continuing decline in the output of business equipment reflects recent cutbacks in real spending for plant and equipment. Output of consumer durables also declined in October. As a result of the automobile strike, new passenger car assemblies plummeted in October by 29.0 percent following the 33.6 percent decline in September. Compared with automobile production in October 1969, output was down 53.0 percent. Output of other consumer durables in October was also off from the September level.

New orders for manufactured durable goods (see Chart I) dropped sharply in October by 3.9 percent to a seasonally adjusted level of $28.7 billion, marking the third successive monthly decline. In the last two months, however, the movements in this series have been centered in industries affected by the automobile strike, so that new orders for total durables are probably giving an overly bleak picture of the underlying orders situation. In the producers' capital goods sector, new orders slipped

Chart I
NEW ORDERS FOR DURABLE GOODS
Seasonally adjusted



Source: United States Department of Commerce, Bureau of the Census.

slightly in October by 1.3 percent to a seasonally adjusted $6.7 billion, but only after posting a large 7.3 percent gain in September. For the third quarter as a whole, orders for capital goods increased 4.9 percent over the second quarter, reversing a downward trend that began in the third quarter of 1969. Sales of all durable goods manufacturers fell 4.8 percent in October to a seasonally adjusted level of $29.4 billion. Nevertheless, durables sales again exceeded new orders, as has been the case in nine of the first ten months in 1970. Thus, the backlog of unfilled orders for durables declined to a seasonally adjusted $78.8 billion, the lowest since September 1967.

Inventories of manufacturers swelled by $0.6 billion in October on a seasonally adjusted basis, well above the $0.3 billion average increase for earlier months this year. The accumulation of inventories was widespread among durables and nondurables industries. At the same time, there was a sharp decline of $1.5 billion in sales, of which more than two thirds occurred in the transportation equipment and primary metals industries. Thus, while the inventory-sales ratio for nondurables edged up only slightly, the ratio for the durables sector advanced to the highest level since 1958. However, since much of the decline in durables sales is strike related, it appears that this ratio somewhat overstates the problem of excess stocks. In September, the latest month for which complete data on trade inventories are available, the inventory accumulation of wholesalers and retailers outpaced sales and the inventory-sales ratio rose moderately.

CORPORATE PROFITS AND CASH FLOWS

Corporate profits before taxes, excluding the effects of price changes on the value of corporate inventories, grew by $1.5 billion to a seasonally adjusted annual rate of $79.0 billion in the third quarter.* This rise in profits followed a $0.8 billion increase in the second quarter. Despite these recent increments, however, pretax profits in the latest quarter were more than $8 billion below the early 1969 level. Profit margins—as measured by the ratio of after-tax corporate profits to gross product originating in nonfinancial corporations—rose slightly in the third quarter but remained low by historical standards.

To a large extent the modest advance in corporate profits in the third quarter stemmed from factors relating to the business cycle. Real corporate product increased, while employment and hours declined further, yielding a fairly large increase in productivity. Thus, although the pace of compensation per man-hour accelerated somewhat, the rate of advance in unit labor costs was low by recent standards. The growth in corporate profits suggests that price increases were more than large enough to offset the expansion in labor and other costs. As noted, however, in the third quarter, this configuration of events was associated with a sharp gain in productivity which far exceeded the normal long-run growth of real output per man-hour. In coming quarters, further gains in profits may depend on maintaining a better balance between rates of increase in compensation and in productivity. Given recent trends in wages and the possibly cyclical nature of the large productivity gains of the last two quarters, the near-term outlook for profits is by no means clear. The persistent cost pressures and the depressed ratio of profits to gross product suggest that business

* The Commerce Department has revised its preliminary estimate of third-quarter gross national product (GNP) in current dollars upward by $0.3 billion to a seasonally adjusted annual rate of $985.5 billion. Also, the implicit price deflator for GNP was revised slightly upward by 0.07 percentage point. The revision in current-dollar GNP was the net result of a $1.5 billion addition to nonfarm business inventories and a $1.2 billion subtraction from "final expenditures", which was distributed fairly evenly among all categories.

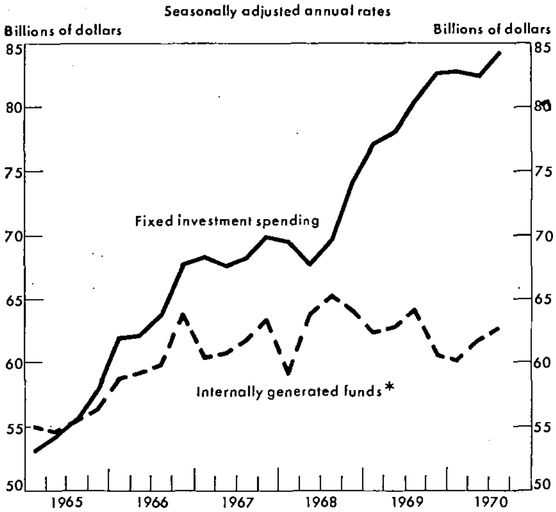
may seek to maintain current profit positions by passing on the higher costs in the form of higher prices.

As a result of the depressed levels of corporate profits during the past year, the flow of internally generated corporate funds has fallen relative to the levels in 1969. This flow is the sum of corporate retained earnings, net of price-induced changes in the book-value of inventories, and capital consumption allowances. During the third quarter of 1970, the flow of internally generated funds into nonfinancial corporations was $1.4 billion less than the level prevailing in the same quarter of last year, though $1.1 billion higher than in the second quarter of 1970. As a consequence, funds acquired in the financial markets have become an increasingly important source of financing for plant and equipment spending (see Chart II). Thus, capital spending is likely to continue to be heavily influenced by developments in the money and bond markets which affect the cost and availability of external business financing.

CAPITAL SPENDING AND RESIDENTIAL CONSTRUCTION

Business spending plans for new plant and equipment have been scaled down substantially over the course of this year. According to the Commerce Department-Securities and Exchange Commission survey taken in the first quarter of 1970, businesses planned to step up their capital spending by about 10 percent during 1970. This planned percentage increase for the year was pared down in subsequent surveys, however, and the November survey indicates that plant and equipment spending in 1970 will rise by only 6.6 percent, a finding that confirmed the results of the previous August survey. Looking ahead to 1971, the latest Commerce-SEC survey calls for little change in capital spending during the first half of the year. This is consistent with the fall survey by McGraw-Hill, which indicated that businessmen plan to spend only 2 percent more on new plant and equipment in all of 1971 than in 1970. Since businessmen also reported that they are expecting a 7 percent rise in capital goods prices, present plans call for an outright cutback in physical investment in plant and equipment in 1971 relative to 1970. In the manufacturing sector alone, planned capital spending for the first half of 1971 is actually below current levels even in dollar terms, and this outlook seems to be consistent with the figures on capital appropriations by the nation's 1,000 largest manufacturers. While net new appropriations on a seasonally adjusted basis increased 8.3 percent in the third quarter, they remained 10.3 percent below those in the same quarter of 1969.

Chart II
INTERNAL FUNDS AND FIXED INVESTMENT SPENDING OF NONFINANCIAL CORPORATIONS
Seasonally adjusted annual rates



* Internally generated funds are the sum of depreciation and other capital consumption allowances plus retained earnings.

Source: Flow of Funds (Board of Governors of the Federal Reserve System).

While capital spending plans for 1971 are still somewhat indefinite and subject to change, the incentives for capital spending certainly have been weakened by developments in 1970. According to the Federal Reserve Board's index of capacity utilization, manufacturers in the third quarter were operating at 76.2 percent of their estimated capacity, down 1.8 percentage points from the preceding quarter and down 8.0 percentage points from a year earlier. Production must grow at a rate faster than expansion in capacity for the rate of utilization to increase; unless utilization does increase, an important incentive for businesses' expanding their facilities will be lacking.

In contrast to many other areas of the economy, homebuilding activity continues to gather strength. In October, housing starts increased 3.1 percent over September to a seasonally adjusted annual rate of 1,550,000 units. During the third quarter, new housing units were begun at an annual rate of 1,511,000, which was 21 percent above the average for the first quarter and the highest rate since the second quarter of 1969. October's gain was in multifamily units, with single-family units dipping slightly. Accompanying October's increase in units begun was a hike in residential building permits. After increasing 3.4 percent in September, permits spurted again by 10.4 percent in October to a seasonally adjusted annual rate of 1,514,000 permits. Since permits have been generally preceded by mortgage commitments, it is only a question of time before these permits translate into actual starts.

EMPLOYMENT, INCOME, AND CONSUMER DEMAND

The labor market statistics for October and November are very difficult to interpret. On balance, however, these data provide little grounds for optimism. After nosing up slightly by 0.1 percentage point in October, the seasonally adjusted unemployment rate increased again in November by 0.2 percentage point to 5.8 percent. Since the household labor survey considers striking workers as employed, the unemployment rate in October and November was affected by the automotive strike only insofar as workers laid off by GM and related industries contributed to the rise in joblessness. The October-November rise in the unemployment rate centered in the adult women and teen-agers categories.

Payroll employment in October dropped by 315,000 to a seasonally adjusted 70,216,000, the lowest level since May 1969. Since striking workers are not receiving paychecks, these persons are not considered employed in the payroll survey. To some extent, the decline in payroll employment in October was the result of the automobile strike. Decreases in manufacturing jobs alone amounted to around 560,000 workers, of whom about 325,000 were striking auto workers. An undetermined, but probably quite substantial, proportion of the remaining 235,000 were workers laid off as a result of the strike. In November, payroll employment declined again. Since the automotive strike had not ended when the November survey was taken, the results for this month were also affected by the strike. Almost all the November decline in payroll employment centered in the manufacturing sector, presumably in part reflecting secondary strike-related layoffs. During October and November, average hours worked were essentially unchanged from their low September levels.

In October, personal income declined by \$2.4 billion to a seasonally adjusted annual rate of \$809.5 billion. Wage and salary disbursements were down fully \$5.3 billion, largely reflecting the decrease in payroll employment. However, about \$2 billion of this decline in wage and salary income was also due to the temporary boost given the September total by the nonrecurring payment to postal workers of the retroactive portion of their pay raise. In the private sector, the largest declines were in the transportation equipment and primary metals industries where the GM strike had its largest direct and indirect effects. The drop in total personal income was held to only about half the fall in wage and salary income largely because of a gain of nearly \$2 billion in transfer payments. The major factor in the latter increase was, however, a nonrecurring payment of retroactive benefits to retired railroad workers.

The automotive strike, which began in mid-September, had widespread effects on the economic aggregates for October. With respect to retail sales, the strike had a double-edged effect. Many potential buyers refrained from making any new car purchase, with the result that sales of domestically produced automobiles declined 13.3 percent in October. Consequently, the fall in durables retail sales swamped a modest 1.0 percent increase in nondurables retail sales. Moreover, the strike imposed a drastic loss of income on many workers, forcing them to tighten their belts. Now that a settlement has been negotiated, both these effects should unwind themselves with a resultant stimulus to retail sales. Overall, retail sales have been quite sluggish; during the first nine months of this year, they rose only 3.9 percent over the level of the corresponding period in 1969. This dollar gain fell short of the increase in prices over the same period, so that in terms of physical volume real retail sales actually fell.

Additional evidence of consumers' hesitancy is seen in the substantially reduced rates of increase in consumer credit outstanding. For the first ten months of 1970, the seasonally adjusted net increase in instalment credit, —that component of consumer credit most closely related to the purchases of goods—was down more than 50 percent from the similar period last year. The net change in instalment credit is the difference between new extensions and repayments on outstanding obligations, and all the decline resulted from a marked slowing in the rate of new extensions.

PRICE DEVELOPMENTS

The consumer price index rose at a seasonally adjusted annual rate of 6.4 percent in October, well above the average monthly increase of 5.4 percent for the first nine months of 1970 and even above the average monthly increase of 6.1 percent in 1969. Since food prices increased very slightly in October, the overall rise was attributable primarily to advances in prices of nonfood commodities and services. Nonfood commodities prices, adjusted for seasonal variation, rose at a rapid annual rate of 6.8 percent, primarily as a result of advances in new automobile and apparel prices. Prices of services rose at an annual rate of 6.1 percent in October, down considerably from the average monthly increase of 8.5 percent for the first nine months of 1970.

After increasing slightly in October, seasonally adjusted wholesale prices in November dipped back to the September level. However, this relative stability masks fairly substantial movements in the components of the total index. Wholesale agricultural prices plunged in October at an annual rate of 16.2 percent and, according to the preliminary estimate, declined an additional 5.1 percent in November. On the other hand, industrial commodities prices increased sharply in October at an annual rate of 7.5 percent, with extremely large gains being recorded for prices of fuels and transportation equipment. However, the preliminary November estimate indicates that wholesale prices of industrial commodities were unchanged. For the year ended November 1970, wholesale industrial prices have advanced 3.6 percent, compared with the 4.0 percent increase over the preceding twelve-month interval.